

***Murābaha* -An Islamic Financing Mode and the Challenges vis-a-vis the International Accounting Standards**

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Abstract

The following paper on *murābaha* explores the challenges vis-a-vis the International Financial Reporting Standards (IFRS). Some aspects are first analyzed and then compared to specific IFRS, namely IAS 2-Inventories, IAS 23-Borrowing Costs, IAS 16-Property, Plant and Equipment, IAS 18-Revenue, IAS 40-Investment Property, and taxable income. *Murābaha*, a method of Islamic Financing with its fixed profit margin, offers the seller a more predictable income stream, however, it is also a controversial issue in the Islamic world of finance due to the sensitivity of the profit margin as opposed to interest. From IFRS's point of view, there are controversies between IFRS and *murābaha* applications. The paper tries to explain the controversies and proposes solutions to overcome the reporting differences between *murābaha* applications and IFRS.

Keywords: *Murābaha*, Interest-profit Margin, IFRS, IFAS-1, Islamic Bank, *Wakālah*, Brokerage Fee.

1. Introduction to *Murābaha*

The following information is taken from the State Religious Secretariat of Turkey: In Islamic law profit is *halal*-legitimate and interest is *harām*-illicit. Interest has been forbidden in 275th and 276th verses of Al-Baqarah Surah (chapter) of Qur'ān. 275th verse says that "those who utilize interest will be in a situation as such that the devil has beaten them. This is because their saying that "interest is just like shopping." But, God has declared interest illicit and shopping legitimate. If anybody upon receiving an advice from the God gives up receiving interest, the interest that they already received is theirs. Their situation will be decided by God (God might forgive them). Whoever returns to interest they deserve the hell.

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They will stay in the hell forever.” Verse 276 says that “God will devastate any goods possessed through interest and fecundate the charities. God does not like any sinful, ungrateful.” In addition to the above, there are other verses of Qur’ān that mention the detriments of interest.

According to Pakistan’s Securities and Exchange Commission’s notification on Islamic Financial Accounting Standards-IFAS-1, *murābaha* is a particular kind of sale where the seller expressly mentions the cost he has incurred for a commodity to be sold and sells it to another person by adding some profit or mark-up thereon which is known to the buyer. Thus *murābaha* is a cost plus transaction where the seller expressly mentions the cost of a commodity sold and sells it to another person by adding mutually agreed profit thereon which can be either in lump sum or through an agreed ratio of profit to be charged over the cost, thus resulting in an absolute price¹.

According to IFAS-1 (paragraph 1.2) *murābaha* is one of the most popular modes used by banks in Islamic countries to promote *riba* /interest free transactions. The ratio in which this instrument is being used varies from bank to bank. It is practically for the reason that Islamic banks are not able to use *muḍārabah* and *mushāarakah* - the trust based participatory modes that cannot guarantee banks any income. *Murābaha*, with its fixed margin, offers the seller (i.e. the bank) a more predictable income stream. A participatory mode like *muḍārabah*, conversely, is preferable as it distributes the risks more equitably between the parties and may lead to better result with regard to socio-economic justice. For example, in the *muḍārabah* based deposit contract between the depositor and the Islamic Finance Institution, profit is not guaranteed. The depositor has to take the risk to end up with a profit share or bear the loss. If there is loss in the business, both parties have to bear it in one way or the other. Since, in *murābaha*, as practiced by Islamic banks, there is a fixed returned guaranteed without a major risk and the risk non-fulfilment of the requisite Shari‘ah conditions, it has become a controversial mode among the scholars. There are other financial instruments in Islamic finance like *ijārah*, *istisna’*, *salam*, and various kinds of *sukuk*, but no explanations will be given here as the subject of the paper is intended to concentrate on *Murābaha*.

¹ Securities and Exchange Commission of Pakistan, Islamabad, Notification on August 24, 2005, Islamic Financial Accounting Standards-IFAS 1, *murābaha*; http://www.secp.gov.pk/notification/pdf/SRO_865_IFAS_Murabaha.pdf

2. *Murābaha* Structure

Originally, *murābaha* is a particular type of sale and not a mode of financing, however considering the practical difficulties in *muḍārabah* and *mushārah* instruments, contemporary scholars have allowed the use of *murābaha* on deferred payment basis as a financing technique (Akhtar, 2005). There are normally three parties in a *murābaha* business, namely a supplier, a customer and an Islamic Bank. The possible transaction flow is given below:

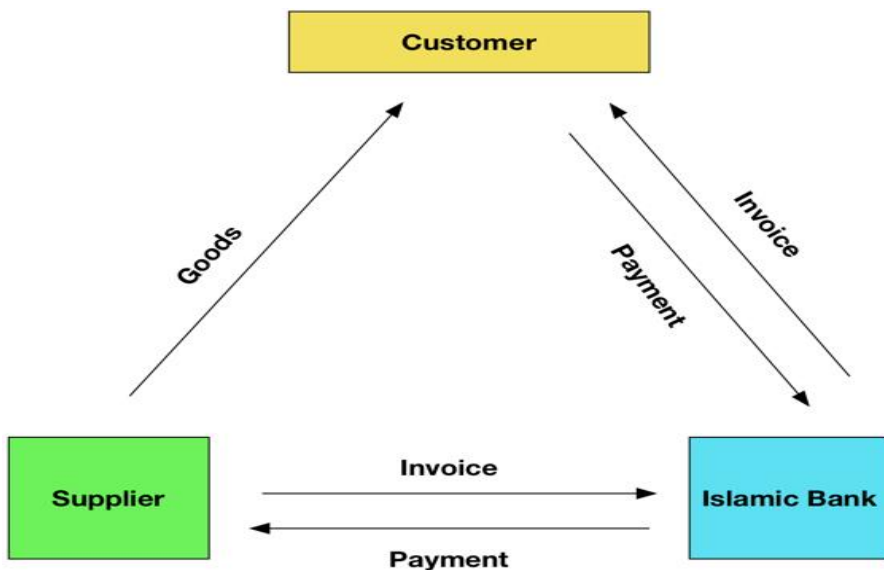


Figure 1

Firstly, the customer who intends to get *murābaha* facility and the Islamic Financial Institution (IFI) agree on a *murābaha* facility agreement. Then, the supplier, which has to be a third party, and the customer, who normally serves as agent for the IFI to get possession of the goods, agree on the type, price, quality and quantity and the payment terms of the goods to be delivered to the customer. The goods are delivered by the supplier to the customer. The invoice is sent to the IFI /Islamic bank) by the supplier. IFI prepares another invoice adding agreed profit margin and sends it to the customer. Supplier receives the payment on time as agreed with the IFI. Customer pays the IFI on an agreed payment date(s) after receiving the IFI's invoice.

Let's make the case clearer with an example: Customer, as IFI's agent, buys goods (aggregate) from the supplier on the terms:

Price : \$50/tonne (the market value at the time of the purchase).

Payment : 30 days after the invoice.

Quantity : 20 tonnes

Quality : Agreed between supplier and customer.

Customer enters into another agreement with the IFI. Their terms are:

Profit margin: 2.5%/per 3 months or \$25 per \$1,000 worth of aggregate purchase.

Payment : 3 months after the invoice.

Supplier sends the goods on April 1 to the customer and the invoice of \$1,000 (GST or VAT is ignored) to the IFI and is paid on 1st May by the IFI. IFI receives the invoice (that is the principal lent) and prepares another invoice (dated April, 1) to the customer of \$1,025 payable on July 31. Customer receives the invoice and makes the payment to IFI on July 31. The IFI's income from this transaction is \$25. The IFI is facilitating the buyer to make a deferred payment for the product.

The profit margin in the example has to be compatible with interest rates applied in the market in a liberal economy, otherwise the IFIs operations will not be viable or only be directed to those companies who are the subsidiaries of parents whose domicile is Sharī'ah ruled countries or companies that do not want to do business with interest at all.

3. Review of Selected Literature on the Use of *Murābaha*

To facilitate a significant number of stakeholders, Islamic banks execute numerous functions. This incorporates the pool of funds through the recognition of deposits. These funds are therefore forwarded to entrepreneurs or firms for dynamic and fruitful ventures to breed profits. In addition, Islamic banks offer interest free products to dish up the diverse economy segments in compliance with Sharī'ah principles. Moreover, the Islamic bank is to endorse and encourage trade behavior as a dynamic interaction of the economy (Naveed, et al., 2011). Dusuki (2007) reports evidence showing that *murābaha* and other mark-up related instruments represent 86 per cent of financing in Islamic banks in the Middle East and North Africa, 70 per cent in East Asia, 92 per cent in South Asia and 56 per cent in Sub-Saharan Africa.

Experts in Islamic economics and finance generally advise the use of profit/loss sharing modes and discourage extensive use of *murābaha* or other trading modes. But, its permissibility is beyond doubt and all Islamic banks operating in the world are using this technique excessively as an alternative to the conventional modes of credit...(Ayub, 2008). Admittedly, this status quo on the regulatory context of Islamic finance has allowed it to expand at a rapid rate. PricewaterhouseCoopers (a multinational professional services firm) estimates the growth rate globally at 15-20% annually (Kan, 2012). But here's the catch: most of the contemporary Muslim scholars agree that there is no minimum time interval for the bank to own and hold the property before selling it to you at the markup. According to Timur Kuran-Professor of Economics and Law at University of Southern California, the typical interval is "under a millisecond." The bank transfers ownership of the asset to its client right away. The client still pays a fixed markup at a later date, a payment that is usually secured by some sort of collateral or by other forms of contractual coercion. Thus, in practice, *murābaha* is a normal loan (MacLean, 2007).

Although the form of *bai' al-'inah* (buy-back) and alternative *tawarruq*-based commodity *murābaha* (buy on credit, sell in cash) have different forms, both instruments serve the same economic substance. In both cases, the transaction is liquidity management for one party and resource mobilization for the other. There is no touch to economy in the form of trade finance, infrastructure development or financing industry. In this form, both instruments are akin to disguised loans in conventional financing (Masood, 2010). Although International Accounting Standards Board (IASB) has made an effort to recognize the Islamic finance realities and established a forum and task force to accomplish the application of IFRS in Shari'ah ruled countries, there are still application gaps of the accounting principles among the Islamic countries.

Murābaha is still a controversial issue in the Islamic world of finance due to the sensitivity of the profit margin as opposed to interest. Securities and Exchange Commission of Pakistan's notification regarding Islamic Financial Accounting Standards-IFAS 1 (Clause 1.4) states, "It should be emphasized here that the instrument of *murābaha* should be used as a transitory step taken in the process of Islamization of the economy, and its use should be restricted only to those cases where the *muḍārabah* and *mushārah* are not practicable".

Commodity *murābaha* is one of the most commonly used financing techniques in Islamic banking. But some court decisions in the matter recently going against Islamic banks in Malaysia have put the people in a

quandary; it is being increasingly asked if commodity *murābaha* defies Islamic requirements. The answer is: in principle it does not. Commodity *murābaha* falls in the same generic category of '*uqud al-mu'āwadāt* or exchange contracts that covers all types of transactions Islam allows (Zubair, 2008).

The Sharī'ah board of a banking institution in Malaysia may approve a financial product as being Sharī'ah compliant, but that same product may not be acceptable or approved in a country within the Gulf Cooperation Council. Malaysia, Pakistan, Sudan and Iran have set up Sharī'ah boards for approving banking standards at the level of the central bank. In most other countries, the finance industry appoints its own Sharī'ah board, which in many cases, is at the institutional level, that is, within each bank or finance house (Frederick & Scheherazade, 2011). In independent auditors' report of Islamic Bank of Britain as at December 31, 2008 (<http://www.islamic-bank.com>), the auditors KPMG Audit Plc. of London, in the opinion paragraph state that:

In our opinion:

- The financial statements give a true and fair view, in accordance with IFRSs as adopted by the EU, of the state of the Company's affairs as at 31 December 2008 and of its loss for the year then ended;
- The financial statements have been properly prepared in accordance with the Companies Act 1985.

The above two points purport that Islamic banking activities have been in compliance with European Union-EU financial reporting standards and British Companies act of 1985. On the income statement of the auditors' report, there is not any interest income of the bank but instead there is "Income receivable from "Islamic financing transactions" which constitutes the major source of income of the bank made of commodity *murābaha* and *wakālah* (brokerage) transactions.

4. *Murābaha* Versus -International Accounting Standards (IAS)

(a) *Murābaha* versus IAS 2-Inventories

In terms of Generally Accepted Accounting Principles (GAAP) and International Financial Reporting Standards (IFRS), the above transaction has some controversies as far as IAS 2-Inventories, is concerned. For the customer, the supplier invoice comes through the IFI with a profit margin

of 2.5% or \$25 for an invoice of \$1,000. That means the GAAP rule for presentation of inventory is violated. In general, inventories are valued at the “lower of cost and the net realizable value” (Mirza & Holt, 2011, p.32). In the case above, inventory is valued above the net realizable value-NRV which is a reflection of the market price of \$50 per tonne. If the company is operating in one of those countries where Islamic Sharī‘ah rule apply in public life, there will not be any controversy as far as the domestic rules applied for accounting purposes. What if the company is a subsidiary of a parent whose domicile is US or Europe or it is domiciled in a Sharī‘ah applying country but wants to apply IFRS based reporting? In this case the company will do some adjustments on its inventory. That means the difference of \$25 in the above example will be taken out of the inventory and posted as the interest expense on the income statement in its reporting to parent on IFRS terms or call it differently but still as an expense on the income statement if the company is domiciled in a Sharī‘ah applying country.

(b) *Murābaha* versus IAS 23-‘Borrowing Costs’

The \$25 difference in the above example creates another disagreement with IAS 23-Borrowing Costs. IAS 23 prescribes the criteria for determining whether borrowing costs can be capitalized as part of the cost of acquiring, constructing, or producing a “qualifying asset.” The standard prescribes the capitalization of borrowing costs into the cost of a “qualifying asset.” Assets that are ready for their intended use or sale (like aggregate) when acquired are not qualifying assets as envisioned by this standard. Qualifying assets, for the purposes of this standard, are assets that take a substantial period of time to be ready for their intended use. Examples of qualifying assets include;

- A toll bridge that takes a couple of years to construct before it is ready for use and is opened to public.
- A power plant that takes a substantial period of time to get ready for its intended use.
- A hydroelectric dam that services the needs of a village and takes a considerable period of time to construct.

Inventories that are routinely manufactured or are produced on a repetitive basis over a short period of time are obviously not qualifying assets. However, inventories that require a substantial period of time to bring to saleable condition can be regarded as qualifying assets for the purposes of this standard (Mirza & Holt, 2011, p.191-193).

If the company in the above example constructed power generators to sell and every generator would be produced based on customer orders and would take about a year to finish, then the company would not have enough cash to finish each generator by its own means. The company would then borrow from a bank or ask for an IFI for a *murābaha*. Let's assume that completing an electric power generator costs \$1,000,000 and one year to complete without profit share or interest. The company would make a *murābaha* with an IFI on the same conditions as the above example. Assuming that the company started to manufacture the power generator at January 1 and completed the production at December 31, the cost of the generator would be shown as \$1,025,000 on its balance sheet as at December 31 (assuming interest charge is 2.5% per annum).

From IAS 23 'Borrowing Costs' point of view, there will be no controversy since a power generator is a qualifying asset. And there will be no concern from IAS 2- Inventories point of view because lower of cost and NRV rule are satisfied since a power generator is a unique-qualifying asset not produced on repetitive basis (it is produced based on customer order and every power generator's specifications may not be alike) and there is no ready market for each generator to trade. When the asset - inventory is sold and delivered to the customer in the following year, the \$1,025,000 worth of inventory item will be posted to income statement as cost of goods sold (COGS) and it will match against the revenue in the same year.

In the aggregate example that of \$25 profit margin per tonne should be expensed in all circumstances since aggregate is not a qualifying asset and no matter what the inventory turnover is. Aggregate could be a final product purchased for resale or an ingredient used in the production of another product (i.e. rolling mixed concrete), still that \$25 should be expensed (as an interest expense per IFRS) in the period of purchase.

(c) *Murābaha* versus IAS 16- Property, Plant and Equipment (PP&E)

What would happen if the qualifying asset is not an inventory but a fixed asset? In this situation the profit margin would be posted to income statements in arrears. Let's assume that in the above power generator example, the power generator is not an inventory being built by the company but a fixed asset purchased from a supplier through *murābaha*. Assuming its useful life is 10 years and the residual value is zero and the company uses straight line depreciation method. In this case the \$25,000 profit margin will be posted into income statement by means of annual

depreciation in ten years. The annual depreciation charge will be $(\$1,025,000/10)$ \$102,500 of which \$2,500 will be the charge of profit margin into income statement on an annual basis. The capitalization of \$25,000 is regarded as a finance cost due to a deferred payment (and it is included in the invoice issued by IFI) and does not create any controversy with regards to IAS 16, Property, Plant and Equipment, since it's part of the cost.

(d) *Murābaha* Versus IAS 18-Revenue

According to IAS 18-Revenue standard, a sale is recognized when the risks and rewards are transferred to the buyer. The buyer, by being issued an invoice and having possession of the goods, takes all the risks and rewards from the sale in *murābaha*. The question here is whether the profit margin on the sale's invoice is part of the revenue or is it an interest income? The following information has been taken from Deloitte's website on IFRS (<http://www.iasplus.com>): According to IAS 18 paragraph 9: "Revenue should be measured at the fair value of the consideration received or receivable". Based on the explanation above the profit margin should be regarded as interest revenue for IFRS purposes. In the numerical example above the \$25,000 profit share of the IFI should be stripped off from the revenue and be recorded as interest revenue. But recording an interest revenue is not possible from Sharī'ah-IFI's point of view.

It might be stated that the issue of revenue recognition under *murābaha* (FAS- 2) falls within the scope of IAS-18 "Revenue". The IAS 18 requires the separation of a trading profit margin from a financing charge for credit, which is an interest-based instrument. The profit is recognized when the asset is made available for sale to the buyer (IAS-18; pars: 14-19), while interest is recognized on a time proportion basis over the credit period [IAS-18; para 30 (a)]. By contrast, in a *murābaha* sale, the seller's profit mark-up is not divisible into two components, a profit margin and charge for credit, since the latter would be a form of *riba*, which is prohibited by Islamic Sharī'ah. Therefore, the accounting treatments for profit recognition fairly reflect the substance of Sharī'ah compliant transaction for which the splitting of the mark-up as required for interest based financial instrument would be inappropriate. Hence the *murābaha* accounting treatment of profit recognition is incompatible with IAS-18 (Baderldin, 2003).

Since interest is forbidden, in our opinion it could be recorded as *wakālah*/brokerage fee revenue. In fact the position of the IFI in *murābaha*

transactions can be construed as brokerage since the buyer and the supplier both agree on the price, quality and payment terms of the commodity being traded. All IFI is doing is acting as an intermediary between the two parties and supplying funds to the buyer to have the transaction realized. Once the invoice issued by the IFI to the buyer, there should appear two lines of information, one is revenue from commodity sales and the other is the brokerage fee or commission revenue.

(e) *Murābaha* versus IAS 40-Investment Property

Referring to the Deloitte's website on IFRS (<http://www.iasplus.com>): According to IAS 40 paragraph 5: Investment property is property (land or a building, or part of a building or both) held (by the owner or by the lessee under a finance lease) to earn rentals or for capital appreciation or both. Paragraph 30 of the same standard permits entities to choose between: i) a fair value model, and ii) a cost model.

One method must be adopted for all of an entity's investment property. Change is permitted only if this results in a more appropriate presentation. IAS 40 notes that this is highly unlikely for a change from a fair value model to a cost model.

From *Murābaha* point of view, fair value model would create a problem since IFI's invoice to the buyer would include the profit margin. However, there is an option for the IFI to split the invoice value of the building (or land) between fair value and the brokerage fee, just like the one suggested for IAS 18 applications. For land and building transactions, there are other options from Islamic finance perspective like “diminishing *mushārakah*.” However, our approach is here only restricted to *murābaha* and the challenges it brings vis-a-vis the IFRS.

5. Challenges with Regards to Taxable Income

There is a problem that in conventional banking the lender would deduct the interest paid from taxable income, however, if the lender is using *murābaha*, it will be paying the price of the good (including the profit) and hence, the profit margin wouldn't be tax deductible. Such an issue has to be dealt within the tax regulations, that when such an issue arises, the profit margin (the interest portion) of the IFI should be deductible from taxable income.

6. Conclusions

In this study, we explored the *murābaha* transactions vis-a-vis the IFRS requirements and reached the following conclusions:

- IAS 2-Inventories perspective: There is no conflict between the IFRS and *murābaha* as long as the goods are qualifying assets for the buyer. If the goods are not qualifying assets, then the profit margin should be stripped off from the cost and recorded as interest expense.
- IAS 23-Borrowing Costs perspective: There is no conflict between the IFRS and *murābaha* as long as the goods are qualifying assets for the buyer. If the goods are not qualifying assets then the profit margin should be stripped off from the cost and recorded as interest expense.
- IAS 16-Property, Plant and Equipment perspective: There is no conflict between the IFRS and *murābaha* since PP&E assets are usually qualifying assets for the buyer.
- IAS 18-Revenue perspective: There is a collision between IFRS and *murābaha* from IFI's point of view since IFI's invoice is issued to the buyer including the profit margin. Here, our proposal is to split the invoice value between the asset's fair value as revenue from the sale (which is the cost to IFI) and the commission from the brokerage (profit margin).
- IAS 40-Investment Property perspective: IFRS-Investment Property accounting gives the buyer the choice of cost and fair value model. As long as the cost model is applied by the buyer there will be no collision between IFRS and *murābaha* (assuming *murābaha* is the financing model). Here, from IFI's perspective, splitting the invoice value is an option.
- Taxable income perspective: The profit margin for the non-qualifying goods in the inventories of the buyer leads to a collision between IFRS and *murābaha*. The profit margin should be stripped off from the value of the goods and recorded as interest expense (or any other expense in Islamic finance point of view) and be deducted from taxable income, otherwise the buyer's taxable income would be higher than what it should be.

Islamic finance is a broad area and growing on a fast pace all over the world. Our study has been limited to *murābaha*; the practitioners may like to give their views on our proposals. Other Islamic finance products (*mushārah, wakālah, ijārah, salam, ṭukuk* etc.) can be analyzed from IFRS point of view. We are of the opinion that there is plenty of room for further research in this area.

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